



Tax Planning For Investors Who Own a Company

Individuals who own a company may benefit from personally investing in a flow-through limited partnership and then rolling it into their company. Such a strategy, structured properly, can be a useful tax planning tool particularly under circumstances where the individual's company has significant net capital loss carry-forwards since such losses can be applied against taxable capital gains that arise on the ultimate disposition of the flow-through investment by the company (flow-through limited partnerships are typically deemed to have an adjusted cost base of zero; therefore, any proceeds received on disposition will be treated as a capital gain for tax purposes).

Below is a step-by-step example of how an individual could utilize a \$100,000 investment in a flow-through limited partnership to not only benefit himself, but also his wholly-owned company - "XYZ Corp", a taxable Canadian corporation. The example assumes the individual has sufficient taxable income to fully utilize all of the tax benefits available and is in a marginal tax bracket of 46.4%. For simplicity, the example assumes no gains or losses are realized in the value of the flow-through limited partnership investment.

\$100,000 INVESTMENT EXAMPLE

Step 1

The individual invests \$100,000 in a flow-through limited partnership and receives a \$100,000 tax deduction in the first year, yielding a personal tax savings of \$46,400.

Step 2

After the initial tax benefits have been realized by the individual personally, he/she then transfers the flow-through limited partnership units (or, alternatively, mutual fund shares if the flow-through units have rolled-over into a mutual fund) to XYZ Corp in exchange for XYZ shares and, under subsection 85(1) of the Income Tax Act, jointly elects to transfer the flow-through units at an adjusted cost base of zero. Utilizing the subsection 85(1) election, there will be no income taxes triggered for the individual on this transfer.

Step 3

At some point in the future, XYZ Corp then sells or redeems the flow-through or mutual fund assets. XYZ Corp will then realize a \$100,000 capital gain, \$50,000 of which will be taxable and the taxable capital gain can be sheltered should XYZ Corp have any net capital losses carried forward. One-half of any prior capital losses and the \$50,000 non-taxable portion of the capital gain would be included in XYZ Corp's Capital Dividend Account. The positive balance, if any, of the Capital Dividend Account could then be paid out in the future as a tax-free dividend to the shareholders of XYZ Corp (assuming the company has cash to pay the tax-free dividend).

In summary, the original \$100,000 investment will provide:

- An immediate tax savings of \$46,400 to the individual;
- A \$50,000 taxable capital gain to XYZ Corp which can be sheltered using any net capital losses carried forward by XYZ Corp;
- The opportunity for a tax-free dividend to the shareholders, from the Capital Dividend Account, of XYZ Corp.

Note: A corporation (including a holding company) can also purchase units in a flow-through limited partnership directly in order to reduce taxes within the entity on the same basis as an individual⁽¹⁾. Not only can the flow-through limited partnership investment allow a corporate investor to reduce its taxes overall, but the conversion of taxable income to capital gains will create capital dividend account additions that can then be distributed to shareholders without attracting tax in the shareholders' hands⁽²⁾. Using flow-through limited partnerships in this manner can allow shareholders to receive higher levels of cash and after-tax returns from their company.

- 1) This example assumes that the company has a December 31 year-end. Companies with non-calendar year-ends should consult with their tax advisors to understand timing of the deductibility of the flow-through investment.
- 2) A corporation is not subject to alternative minimum tax; however, the investor may need to consider whether corporate minimum tax applies in certain provinces (i.e. Ontario).